Supreme Court of the United States,

OCTOBER TERM, 1922.

No. .

THE PEOPLE OF THE STATE OF NEW YORK,
Petitioner,

AGAINST

LOUIS JERSAWIT, as Trustee in Bankruptcy of AJAX DRESS CO., INC.,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO APPLICATION FOR WRIT OF CERTIORARI.

POINT I.

The equities of the situation, and the plain language of the New York Statute which imposes the Franchise Tax, require that the tax be apportioned. Petitioner's remedy should be obtained by legislation.

The statute imposing the tax in question is Section 209 of the New York Tax Law, which so far as material, reads as follows:

> "*Franchise tax on corporations based on net income.* For the privilege of exercising

> its franchise in this state in a corporate or organized capacity, every domestic manufacturing and every domestic mercantile corporation * * * shall annually pay in advance for the year beginning November 1st next preceding, an annual franchise tax, to be computed by the Tax Commission upon the basis of its net income for its fiscal or calendar year next preceding, as hereinafter provided, upon which income such corporation is required to pay a tax to the United States."

The State Tax Department of New York filed a claim for a franchise tax for the year ending October 31, 1921. The bankruptcy occurred on December 22, 1920. It was claimed, therefore, by the Trustee in Bankruptcy that the bankrupt ceased to exercise its franchise on December 22, 1920, and that the tax being an annual tax for the privilege of exercising the franchise for a year, and it having been exercised but for about two (2) months, that the tax should be apportioned. The District Judge and the Circuit Court of Appeals sustained this contention.

The controversy, therefore, turns entirely upon the language of the statute imposing the tax. The instant case is the first one which squarely presented the necessity for a strict construction of § 209.

The Trustee contends that the above quoted language of the Tax Law makes it clear that the tax is apportionable, it being a tax for the privilege of exercising a corporate franchise *for a year,* and that the tax is imposed annually for such exercise of the franchise *for the year beginning November 1st of each year;* that the basis of the computation of the tax is the net income of the corporation in question for the fiscal or calendar year next

preceding; and that although the tax is denominated a franchise tax, its basis is therefore, an entire year's income of a corporation, and in reality it is an income tax (*People* vs. *Knapp,* 230 N. Y. 48).

Whether the tax is considered to be in reality an income tax, or whether the view taken be that the tax is as it is labelled, a franchise tax, is, however, immaterial in view of the controlling effect of the decision of the Court of Appeals of New York in the case of *People ex rel. Mutual Trust Company* vs. *Miller,* 177 N. Y. 51, which holds that the franchise tax is to be apportioned where the corporation in question did not exercise the franchise for the year for which the tax is imposed. In that case, the annual franchise tax had been imposed upon a trust company although it had only been in existence for six (6) days of the year in question. The company claimed that as it had carried on business but six days before the fiscal year expired the tax should be apportioned according to the period during which it exercised its corporate franchise. The company's contention was sustained by the Court of Appeals.

We quote from the decision of Vann, *J.,* at page 54, as follows:

> "The tax under consideration is not imposed upon property, but upon a privilege. *It is not imposed upon the privilege of becoming a corporation, for that would be an organization tax, payable but once for the entire period of corporate existence.* It is imposed 'for the privilege of exercising' the corporate franchise, and is measured by the value of the investment made and used in carrying on the corporate business. *It is an 'annual' tax, imposed 'annually', as the statute expressly provides, for the privilege of exercising, not of possessing, a*

corporate franchise. This privilege was used by the relator for only six days during the fiscal year in question. It could not exercise its franchise for the entire year, because the state did not bring it into existence until the year had nearly expired. *The consideration for the tax is the privilege of carrying on business, yet the relator, according to the requirement of the comptroller, was compelled to pay for a privilege that it did not have and could not exercise during the greater part of the period for which the tax was laid. It used the privilege for only six days, but it is taxed for using it 365 days, during 359 of which it did no business and enjoyed no privilege.* An annual tax is a tax reckoned by the year the same as annual rent or annual interest. An 'annual' tax imposed 'annually', means a tax that is imposed once a year, computed by the year. If a trust company does not commence business until six days before the fiscal year ends, OR IF IT CEASES TO DO BUSINESS SIX DAYS AFTER THE YEAR BEGINS, THE TAX FOR DOING BUSINESS BY THE YEAR REQUIRES APPORTIONMENT. *While the legislature did not so provide in express terms, it is a fair and reasonable implication from the words used that such was its intention.* When by Section 182 of the Tax Law it imposed an annual tax payable annually upon every corporation of a certain class, to be computed upon the basis of the amount of its capital stock 'employed within the state' during the year, it did not say expressly that the assessment should be determined by the *average* amount of capital so employed, but we held that this was what was necessarily meant. * * *"

This decision was followed by Judge Hough in his opinion in the Circuit Court of Appeals, which opinion is printed as an appendix to this brief.

Judge Augustus N. Hand in his decision in the

District Court holding that the tax should be apportioned, based his argument upon his understanding that the decisions of the New York Court of Appeals have rested upon whether the corporate franchises were actually exercised.

He says (fol. 149 of the printed record):

> "An actual exercise and not the mere right without the power to exercise seem to furnish the test laid down by the New York Court of Appeals."

The only difference between the statute as construed in the *Miller* case, *supra,* from the present statute, is that the tax is now, by amendment, payable annually in advance, but as Judge Hough says:

> "The requirement to pay annually in advance is directory only; the tax was the same tax on the day of petition filed that it was on the first of November. Undoubtedly the State may exact a price for beginning a year's business, or charge the same price for the privilege of transacting business one day or one year. *The question is not one of power, but of language,* and we are of the opinion that the changed language has not changed the nature of the tax."

It is further contended that the language of the statute under consideration points even more strongly to the apportionment doctrine than the statute under consideration in the *Miller* case, *supra,* for Section 209 provides not only that the corporation shall "annually pay" an "annual franchise tax", but in addition uses the words "for the year beginning November first, etc." In addition, it bases the tax upon the entire net income of the corporation for the previous fiscal or calendar year, whereas the tax in the *Miller* case, *supra,* above quoted from, was based upon the amount of the corporation's capital stock surplus and undivided profits.

It is now claimed, however, by the Attorney General, that the reasoning in the *Miller* case, *supra*, which was followed by the Circuit Court of Appeals, is no longer applicable by reason of the decision in *People ex rel. New York Central & Hudson River Railroad Co.* vs. *Gaus*, 200 N. Y. 328, although that point was not before the Court.

So far as that case is concerned it is submitted that it is not a controlling authority for the reason that it did not decide that the franchise tax under Section 209 was not apportionable. That case arose under Section 182 of the Tax Law, *and not under Section 209 which applies to mercantile and manufacturing corporations only.* The interpretation of Section 209 as to the exercise of the franchise was not involved in that case, nor any question as to the exercise of the franchise. Under Section 182 of the Tax Law the franchise tax is based upon the amount of the capital stock of the corporation employed during the preceding year within the state. The Court of Appeals held in *N. Y. C. R. R.* vs. *Gaus, supra* (and we submit that is the only thing decided by the case), that where the capital stock as it existed on November 1st, 1906, had been increased on the following January and remained at the increased amount until the end of the fiscal year, the State Comptroller properly assessed the stock on the basis of the whole outstanding stock at the end of the tax year.

The references to the *Miller* case, in the *Gaus* case, therefore, upon which petitioner so much relies, we submit have no bearing upon the matter decided in that case, and in no way weaken the force of the reasoning in the *Miller* case which the Circuit Court of Appeals followed.

The decision in the case at bar depends upon the

construction of the language of the statute imposing the tax.

> "A statute which levies a tax is to be construed most strongly against the Government and in favor of the citizen. The Government takes nothing except what is given by the clear import of the words used, and a well founded doubt as to the meaning of the Act defeats the tax." (*People ex rel. Mutual Trust Co.* vs. *Miller, supra.*)

Applying this principle, and reading the statute in the light of the decisions of the highest court of the State of New York interpreting similar language in taxing statutes, the conclusion follows that the apportionment of the tax was right and fully warranted by the language of the act. It is not for the court, to say that the price for exercising a corporate franchise shall be the same for one day or for one year.

Surely, the matter can be readily remedied by the legislature, if such be its intention, by amending the statute so as to provide against an apportionment of the tax.

POINT II.

The Court below properly held that a claim for interest at the rate of one per cent. per month in a bankruptcy proceeding is a penalty and should be disallowed.

Section 57-*j* of the Bankruptcy Act provides as follows:

> "Debts owing to the United States, a state, a county, a district, or a municipality as a

> penalty or forfeiture, shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transfer or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued thereon according to law."

The District Judge and the Circuit Court of Appeals held that inteerst on the tax should be allowed up to the date of payment, but that interest at the rate of one per cent. (1%) per month amounts to a penalty and must be disallowed, under Section 57-*j* of the Bankruptcy Act.

There has been some conflict of authority on this question, but we submit that the reasoning *in re Ashland, Emery & Corundum Co.*, 229 Fed. 829, which was followed by both the District Judge and the Circuit Court of Appeals, is sound in principle and a proper interpretation of the Bankruptcy Act.

In that case the Court said at page 831:

> "If the charge here in controversy is to be regarded as interest, the trustee ought to pay it. Penalties, however, stand upon a different footing. It cannot be said that a penalty imposed for failure to pay a tax, is part of the original tax, in the sense that interest is. By 'interest' is ordinarily understood a charge for the use of money or damages for the detention of it. A penalty, as applied to cases of this character, means a punishment imposed for failure to make the payment on time. Section 64-*a* contains no provision for the payment of penalties; and I do not think it can fairly be construed to include them, especially when, as here, the estate was in course of administration during the entire period when they accrued."

and again at page 832:

> "Assuming, however, that it is, it seems to me plain, and I accordingly find, that 1% a month exceeds what is fairly required to make good loss to the state for mere delay in the payment of the tax, and as to such excess is not interest, but constitutes a penalty imposed for failure to pay promptly. The actual damages sustained by the State of New Jersey from the delay are not obscure nor difficult to estimate. What the state lost was the use of the money. Its damages therefore are the commonest form known to the law, and the most certain of estimtaion. They are established by statute in New Jersey for individuals at 6% per annum."

The fact that the statute itself calls it interest would not be conclusive upon the Bankruptcy Court, which has the right and power as well as the duty, to examine and decide the question for itself.

In re Ashland, Emery & Corundum Co. (*supra*).

State of New Jersey vs. *Anderson*, 203 U. S. 483.

In disposing of this branch of the case the Circuit Court of Appeals did not express its views but refers to its decision filed the same day, *in re J. Menist Co.* As the decision is not yet reported we submit as an appendix to this brief the opinion of Judge Hough in the Circuit Court of Appeals in the *Menist* case on this question.

That case holds that a claim in a bankruptcy proceeding for interest at the rate of one per cent. (1%) per month under a taxing statute, in the

absence of proof of pecuniary loss by the state or municipality, is a penalty within the language of Section 57-*j* of the Bankruptcy Act, and cannot be allowed.

POINT III.

The application for the writ of certiorari should be denied, with costs.

Respectfully submitted,

HENRY B. SINGER,
Of Counsel for Respondent.

Appendix.

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT.

Before:

Hon. CHARLES M. HOUGH,
Hon. MARTIN T. MANTON,
Hon. JULIUS M. MAYER,
Circuit Judges.

IN THE MATTER

OF

AJAX DRESS CO., INC., bankrupt.

STATE OF NEW YORK and STATE TAX DEPARTMENT,
Appellants.

APPEAL FROM AN ORDER IN BANKRUPTCY ENTERED IN THE DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

The petition against the above named bankrupt was filed 22d December, 1920, and adjudication duly followed.

Against the estate the State Tax Department filed a claim for a "franchise tax, for period ending October 31, 1921"; the amount claimed being

For tax	$448.34
"Penal interest, etc.".....	87.03
Total	$535.37

The bankrupt was a manufacturing or mercantile corporation of the State of New York. The tax claimed arises under Section 209 of the Tax Law of New York, which, so far as material, reads thus:

> *"Franchise tax on corporations based on net income.*
>
> For the privilege of exercising its franchise in this State in a corporate or organized capacity, every domestic manufacturing and every domestic mercantile corporation * * * shall annually *pay in advance for the year beginning November 1st next preceding,* an annual franchise tax, etc."

The bankrupt ceased actual business on the day of petition filed, so that it exercised its franchise something less than two months out of the twelve months for which the tax was levied and leviable.

The Court below apportioned the tax and allowed of the claim a fraction which represented the portion of the year during which the bankrupt exercised its franchise.

As Ajax Co. had not complied with the statute and paid the tax, the State claimed under Section 219-*c* of said tax law

> "In addition to the amount of said tax, ten per centum of such amount plus one per centum for each month the tax remained unpaid."

The Court below denied this claim, treating it as a penalty, but allowed six per cent. interest on the apportioned tax to the day of the date of actual payment by the Trustee.

From the order embodying this decision the present appeal was taken.

ROBERT P. BEYER, Deputy Attorney General of the State of New York, for appellants; HENRY B. SINGER for the Trustee in bankruptcy.

HOUGH, *C. J.*

The question whether that which the State calls a tax is a tax and a proper tax, produces a federal question under the Bankruptcy Act (*New Jersey* vs. *Anderson,* 203 U. S. 483). Yet under familiar rulings, the construction of a state statute and the definition of its terms are matters on which we should ordinarily follow the authority of the highest state court.

Therefore we regard the first branch of this case as raising only the question whether it is or is not governed by *People* vs. *Mutual Trust Co.,* 177 N. Y. 51.

In that case the operative words of the statute were that the said Trust Company, being incorporated under the law of New York,—

> "shall pay to the State annually for the privilege of exercising its corporate franchise or carrying on its business in such corporate or organized capacity an annual tax", etc.

The Trust Company organized on June 6, 1901, and opened for business on June 24th. A tax was levied for the year ending June 30, 1901, and the state demanded that for the privilege of transacting business for six days it should pay the same tax that it would have paid for doing business three hundred and sixty-five days.

Vann, *J.,* pointed out that the demand was for "an annual tax imposed annually", and for the privilege of "*exercising* not of *possessing* a corporate franchise". Further that it could not "exer-

cise its franchise for the entire year because the state did not bring it into existence until the year had nearly expired". The consideration for the tax was the *privilege* of carrying on business; yet the state was endeavoring to require the relator to pay for a privilege that it "could not exercise during the greater part of the period for which the tax was laid". Further, said the Court, an annual tax imposed annually meant a tax "imposed once a year computed by the year"; and the tax was "measured by an annual business done".

It was further pointed out that in *People* vs. *Spring Valley Co.*, 92 N. Y. 383, there (and here) relied upon by the state,—the question of apportionment had been raised neither by the pleadings nor at trial, and although sought to be raised in the court of last resort, was not considered for obvious reasons.

The question now at bar is whether, since the present statute requires a corporation to pay the tax "annually in advance", the reasons for the Mutual Trust Co. decision have been swept away by changing the language of the statute.

Every reason advanced by the court in the *Mutual* decision is applicable here. The requirement to pay "annually in advance" is directory only; the tax was the same tax on the day of petition filed that it was on the first of November. Undoubtedly the state may exact a price for beginning a year's business, or charge the same price for the privilege of transacting business one day or one year. The question is not one of power, but of language, and we are of opinion that the changed language has not changed the nature of the tax. Comparing the *Mutual* case with this;—both taxes are franchise taxes; both are measured

by business or the means of doing business; both are for the exercise of a franchise; neither is for the possession of a franchise, nor is either a price exacted on giving a franchise; in both the contemplation of law is that the franchise shall cover the business done thereunder for a year.

For these reasons we follow the *Mutual* decision in holding that the tax was properly apportioned below. The case of *New York Terminal Co.* vs. *Gaus,* 204 N. Y. 512, is not applicable; there a receiver had exercised the taxable franchise, and was held taxable thereon and therefor. Nothing of the sort is here suggested.

The inability of the Mutual Company to exercise its franchise for the yearly period was caused by non-existence; the inability of Ajax Co. to do the same is caused by deprivation through bankruptcy of all means of exercising the privilege; the business and logical result is the same. The somewhat sardonic suggestion that had Ajax Co. paid the tax and gone out of business or into bankruptcy in a few days, there would have been some difficulty in getting a rebate from the State, is not persuasive in law, though quite true in practice.

So far as the state's second demand, for penalties and interest is concerned, the matter is covered by our opinion in *Re Menist,* filed today. That decision relates to a claim for interest at one per cent. per month made by the United States in respect of its demand for lawful and unpaid taxes; but whatever is there said is applicable with equal force to the demand of the State of New York, not only for one per cent. a month, but for what is confessedly a penalty and called by that name.

Order affirmed with costs.

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT.

Before:

HON. HENRY WADE ROGERS,
HON. CHARLES MERRILL HOUGH,
HON. JULIUS M. MAYER,
Circuit Judges.

IN THE MATTER
OF
J. MENIST CO., INC., bankrupt.
UNITED STATES OF AMERICA,
Appellant.

APPEAL FROM AN ORDER IN BANKRUPTCY ENTERED IN THE DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

The petition in this matter was filed 20th March, 1920.

On 28th November, 1919, the United States had assessed on Menist's income for 1917 an additional tax of $2,421.75, and required the corporation to pay the same on December 11, 1919. No payment was made.

On 5th May, 1921, the United States filed a claim in this proceeding for the said tax plus five per cent. penalty and one per cent. interest per month until paid.

That the tax was duly levied and is correct in amount are matters not in controversy.

The statutory justification asserted for the demand of interest and penalties is Act of October 3, 1917 (40 Stat. 300, Sec. 212) making Sec. 14(*a*) of the Act of September 8, 1916 (39 Stat. 756) applicable to taxes under the 1917 Act.

By these statutes it is provided that

> "* * * to any sum or sums due and unpaid after the fifteenth day of June of any year, or after one hundred and five days from the date from which the return of income is required to be made by the taxpayer, and after ten days' notice and demand thereof by the Collector, there shall be added the sum of five per centum on the amount of tax unpaid and interest at the rate of one per centum per month upon said tax from the time the same becomes due."

At the hearing below the United States withdrew its claim for the penalty of five per centum, but insisted upon the demand for one per cent. per month under the guise of lawful interest.

The lower Court held that so-called interest at the rate of one per cent. a month amounted to a penalty, and therefore allowed the tax with interest at six per cent. to be computed to the day of the date of payment by the trustee.

There appears to be an error in the transcript as to the time when interest should begin. It has not been insisted upon in argument and may be corrected by agreement.

From the order embodying this decision the present appeal was taken.

VICTOR HOUSE, Assistant U. S. Attorney, for appellant;

E. FICHANDLER for the Trustee in Bankruptcy.

HOUGH, *C. J.*

The fundamental proposition thought to justify this appeal is that a tax is not a debt. This is usually true; taxes are not treated as debts, because the latter are obligations founded on contract, while taxes are imposts levied by government and operating *in invitum* (*Meriwether* vs. *Garrett,* 102 U. S. 472, at 513-514).

But we are here concerned only with the bankruptcy statute, and a tax whether due to the nation, to a state or any other lawful taxing power, is a species of debt under that Act. This is because it is called a debt by the statutory caption of Sec. 64, which is the law invoked, and properly invoked, by the Government in pursuing its present demand (30 Stat., p. 563). Further, this Court has so decided *In re Sherwoods,* 210 Fed. 754 (758), and the point is elaborately and well treated in *Kaw, etc.* vs. *Schull,* 230 Fed. 587.

A tax being then a preferred debt; neither interest nor any other derivative or appended claim can rise higher than the tax debt which gives it birth and being; and it is provided in respect of all debts "owing to the United States, a state, a county, etc." as a *penalty,*—shall not be allowed except for the amount of the pecuniary loss sustained in the proceeding out of which the penalty arose (Sec. 57*j*).

It is a matter almost too plain to require citation, that an exaction may be a penalty without being called by that name (*Fontenot* vs. *Accardo,*

278 Fed. 871, at 874). The question is often one of degree, for no one would doubt that if the statutory rate for withholding a tax was one per cent. a day, the requirement would be treated as a penalty.

Subject to statutory limitation, the rate of interest or, what is the same thing, compensation for the use of money, is ordinarily fixed by agreement of parties. But in tax matters there is no such agreement; one party commands and the other must obey, and again subject to constitutional limitations the commanding party may impose any terms of payment that it pleases, and it makes no difference whether the price of delayed obedience is called interest or penalty or fine or additional tax; every increase over the amount that satisfies the tax if paid the moment it is levied, is merely an additional exercise of the power of the taxing authority.

Since in bankruptcy (and we are solely concerned with bankruptcy) the power of ascertaining the amount or legality of any tax is vested in the Court (Sec. 64*a*) and penalties are not to be allowed except for the amount of pecuniary loss sustained by the delayed payment, the only question here is whether an exaction of one per cent. a month as the price of delay amounts to a penalty (As to nature of interest generally see *Agency, etc., Co.* vs. *American Co.*, 258 Fed. 363, at 372).

On the point at bar we are in accord with *Re Ashland, etc., Co.*, 229 Fed. 829, and hold that, there being no evidence of any injury or damage to the Government by the withholding of this tax except that which flows from the non-payment of a just debt, anything in excess of the legal rate of interest is to be treated as a penalty and not allowed.

The point seems not to have been argued in *Re Kallak,* 147 Fed. 276, *In re Scheidt,* 177 Fed. 599, or *In re Quinones,* 39 A. B. R. 320; but in the implications of these cases we cannot concur. As the question here arises under the Bankruptcy Act.—*United States* vs. *Guest,* 143 Fed. 456, does not apply; there being no reason why a penalty, by whatever name called, may not be, enforced against an individual,—if properly expressed in agreement or statute.

The question remains whether a tax demand duly proved should continue to draw interest at the legal rate after the filing of petition for adjudication. The general rule is of course that interest stops with petition filed (*Sexton* vs. *Dreyfus,* 219 U. S. 339), but a tax debt due to any of the taxing authorities enumerated in Section 64*a* is not only a highly preferred debt, but the section contains specific directions that the trustee shall pay "all taxes legally due and owing". That means legally due and owing in accordance with the provisions of the bankruptcy act, and under that statute Section 57-*j* requires penalties due to the United States, or a State, etc., to be allowed to the extent of the pecuniary loss suffered. The loss continues as much after petition filed, as before.

We agree with the Court below that these directions cannot be fulfilled except by an order on the trustee to pay the tax with lawful interest down to the date of actual payment.

Order affirmed.